CHAPTER 1

INTRODUCTION
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1.1 Introduction

Behavioural finance is the study of investor psychology while forecasting financial decisions. The impact of behavioural factors on decision-making is often ignored by individual investors, and if ignored this hampers the performance of their investment in stock market (Chandra, 2008) Behavioural finance is emerging field which helps investors as well as stock market to encourage investment pattern, Asia is a perfect platform for studying behavioural finance. Moreover, Asia people suffers from several psychological and emotional biases more than Western people do and Asian individual investors are considered as mere gamblers (Kim & Nofsinger, 2008) Decision making by individual investors is based on personal factors such as age, education, income, and investment portfolio, etc. (Chandra, 2008) Capital market plays vital role in promoting and sustaining the growth of an economy (www.bseindia.com). Investors are the key people for any organization they are the one who employ capital with the expectation of safety, liquidity of the invested fund and returns on the investments. Capital market plays a critical role in mobilizing savings for investment in productive assets, with a view to enhancing a country’s long-term growth prospects. It thus acts as a major catalyst in transforming the economy into a more efficient, innovative and competitive marketplace within the global arena (Ministry of Corporate Affairs iepf). “Investors should invest on what they know; the biggest mistake is to invest on what they don't know” (Shell Adam, 2011).
Behavioral finance is the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets.” The science deals with theories and experiments focused on what happens when investors make decisions based on hunches or emotions.

1.1 Conceptual Framework

Investor’s Behaviour

Behaviour is the range of actions and mannerisms made by organisms, systems, or artificial entities in concurrence with their environment, which includes the other systems or organisms around as well as the physical environment. It is the response of the system or organism to various stimuli or inputs, whether internal or external, conscious or subconscious, overt or covert, and voluntary or involuntary (Dusenbery, David B.).

(Shefrin, H, 2001) Behavioural finance is the application of psychology to financial decision making and financial Market. (Kahneman and Tversky) contributed to psychology literature in 1970s served as foundation and gave rise to a new paradigm in the 1980s called Behavioural Finance, which “studies how people actually behave in a financial setting. Specifically, it is the study of how psychology affects financial decisions, corporations, and the financial markets.”(Nofsinger, 2001).

Behavioural Finance closely combines individual behaviour and market phenomena and uses the knowledge taken from both the psychological field and financial theory (Weber, 1999).
Behavioral finance is defined as a field of finance that proposes explanation of stock market anomalies by identifying psychological biases, rather than dismissing them as “chance results consistent with the market efficiency hypothesis.” (Fama, 1998).

1.1 Factors Affecting Decision Making and Investment Performance

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### Heuristic Decision Process

It refers to the method which humans use to make decisions in complex, uncertain environment (Ritter, 2003; Paul, Tarak. 2010).
“Heuristics are simple efficient rules of the thumb which have been proposed to explain how people make decisions, come to judgments and solve problems, typically when facing complex problems or incomplete information. These rules work well under most circumstances, but in certain cases lead to systematic cognitive biases” Daniel Kahneman (Parikh, 2011).

**Representativeness**

This concept lead to new approach that the investors’ recent success will tend to continue into the future and the tendency of the investors to make decisions based on past experiences is known as stereotyping (Debondt, 1998) concluded that analyses are biased in the direction of recent success or failure in their earnings forecasts and this forming of judgments based on stereotypes is known as Representativeness (Paul, Tarak. 2010)

"Representativeness is an assessment of the degree of correspondence between a sample and a population, an instance and a category, an act and an actor or, and between an outcome and a model.” Tversky and Kahneman (1984), In: Gilovich, Griffin and Kahneman (2002).

**Overconfidence**

(Paul, Tarak. 2010) self-confidence is often view as a positive trait sometimes the investors overvalue their analytical skills or presumptuous more knowledge then they have, this may leads to excessive trading.
"Overconfidence is Too Much Trading" (Shefrin, 2000). Psychologists have determined that overconfidence in investors results in overestimate their knowledge, underestimate risks, and overstress their ability to control events. Does overconfidence occur in investment decision making? Security selection is a difficult task. It is precisely this type of task at which people exhibit the greatest overconfidence."(Nofsinger, 2001).

Overconfident investors believed that their skills are very high to compensate for the costs of trading (Odean, 2000).

(Bernardo & Welch, 2001) explained that overconfidence is beneficial in economy because the risk taking by overconfident agents are increased which facilitates the emergence of entrepreneurs who exploit new ideas.

**Anchoring**

Anchoring describes the common human tendency to rely too heavily on one attribute or piece of information when making decisions. As the new information arrived, the investors tend to be slow to change. Some time it is showcased that investors are unlikely to change their opinions even when new information becomes available. (Lord, Ross and Lepper, 1979) (Paul, Tarak. 2010).
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*Gamblers Fallacy*

It arises when the investors inappropriately predict that trend will reverse. This may result in anticipation of good or poor end (Wameru, et.al. 2008): In (Paul, Tarak. 2010).

“The most bizarre case for being bullish is the belief that investor possess is markets can't go down. This is a prime example of the Gamblers’ Fallacy.” (Montier, 2003).

(Kahneman & Tversky, 1971) describes the heart of gambler’s fallacy as a misconception of the fairness of the laws of chance. "Gambler's fallacy comes up with two sorts of confusion they are firstly; people have very poor intuition about the behaviour of random events. Investors expect reversals of trend to occur more frequently than actually happens. Secondly the reliance on representativeness (Shefrin, 2000).

*Availability Bias*

The investors place undue weight for making decisions on the most available information. And this event results in lower returns and at times poor results also (Paul, Tarak. 2010).

Availability heuristic, how easily things come to mind (Tversky and Kahneman, 1973).

(Kahneman and Tversky, 1974) Heuristics influences people in the situation in which people assess the frequency of class or the probability of an event by the ease with which instances or occurrence can be brought to mind.
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*The prospect theory*

Prospect theory, is developed by (Kahneman and Tversky, 1979) this is a second group of illusions which may impact the decision process. Prospect Theory, highlights how people manage risk and uncertainty. In theory depicts several states of mind which may influence an investor’s decision making process. The key concepts which he discussed are as follows:

*Loss aversion*

The investor is a risk-seeker when faced with the prospect of losses, but is risk averse when faced with the prospects of enjoying gains. This phenomenon is called loss-Aversion (Paul Tarak, 2010).

(Barberis and Huang, 2001) Loss aversion refers to the difference level of mental penalty people have from a similar size loss or gain.

*Regret Aversion*

It is a phenomenon arises from Investors’ craving to avoid pain of regret arising from a poor investment decision. Regret aversion encourages investors to hold those stocks whose performance was not well, avoiding their sale tends to avoids the recognition of the related loss and bad investment decision. Regret aversion creates investment strategy called tax efficient, which can help investors to reduce their taxable income by realizing capital losses (Paul. Tarak, 2010).
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*Mental Accounting*

It describes the trend of people to situate particular events into different mental accounts based on superficial attributes (Shiller, 1998).

Mental accounting refers to “the process by which people think about and evaluate their financial transactions” (Barberis & Huang, 2001) Mental accounting explains why an investor is likely to refrain from readjusting his or her reference point for a stock.

*Self-Control*

Self control is required by all the investors at the stage to avoid the losses and protect the investments. (Thaler and Shefrin, 1981) investors are subject to temptation and they want to improve self-control. Investor can control their urge to over consume by separating their financial resources into capital and ‘available for expenditure’ pools,

(Glick, 1957) states that the unwillingness to realize losses constitutes a self-control problem. For instance, Investors who are retired from their job, finance their living expenditures from their portfolios, be anxious about expenses their wealth too speedily, there by outliving their assets.
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**Market Factors**

(Waweru et al. 2008) identified the factors of market that have impact on investors’ decision making: Price changes, market information, past trends of stocks, customer preference, over-reaction to price changes, and fundamentals of underlying stocks.

(Luong et.al. 2011) stated that market factors are not included in behavioural factors as they are external factors which influence investors’ behaviour. However, the market factors influence the investors in different ways, so if market factors are not listed when taking into consideration the behavioural factors impacting the investment decisions is not appropriate.

**Herding Behaviour**

It is a form of heuristics- a state of affairs where investors use practical efforts and experience, trial and error, to come up with “rules of thumb” (Shefrin, 2000).

Herding effect in financial market is acknowledged as tendency of investors’ behaviour to follow the others’ actions. (Waweru et al. 2008,) identified the factors which can have impact on stock investment decisions they are as: buying, selling, choice of stock, length of time to hold stock, and volume of stock to trade.

1.1.3 Decision Making

There are several investment decisions related to stock trading, such as: buying, selling, choice of stocks, length of time to hold stocks, and volume of stocks to trade. However, in this part, two important stock trading decisions: selling and buying are
focused because they have connection to the other decisions, and have high impact on the investment performance.

**The selling decision**

Investors decrease the selling decisions of assets that get a loss in comparison to the initial purchasing price, a trend called the “disposition effect” (Shefrin and Statman, 1985).

(Odean, 1998) recognizes that the average return of sold stocks is greater than that of the average return of stocks that investors hold on.

(Coval & Shumway, 2000) found that investors, according to prospect theory, investors who are having gains (losses) in the first half of trading day tend to take less (more) risk in the second half of trading day.

**The buying decision**

(Odean, 1999) provided various aspects related to the preferable stocks that individual investor’s would like to buy. In the research, selling decisions is prioritize on winning stocks; whereas, buying decisions are related to both prior winning and losing stocks. Researcher states that the buying decisions are may be outcome of an attention effect. When investors are supposed to make a decision of stock purchase, they may not find a good stock to buy after considering thoroughly the thousands of listed securities. They buy those stocks which may caught their interest and the main
cause for attention is because of remarkable past performance of those stocks, it may be even good or bad.

(Barber & Odean, 2002) proved that the selling decisions are less determined by attention than buying decisions in case of individual investors.

1.1.4 Investment performance

(William Sharpe) proposed the “Capital Asset Evaluation Model” in (1964), which proposes that risk-averse investors expect highest returns; and in view of investors risk is measured with standard deviation of rate of returns.

(Liu. Ping-Wen, 1993) Investors have standardized expectation of a rate of returns, which is projected as normal distribution. Investors in capital market expect absolutely risk free investment for over a specified period of time. Capital market is a perfect market, as there is no tax, regulation, information cost, trading cost and assets could have unlimited divisions and no restriction on selling/buying stocks).

(Anderson, Henker and Owen, 2005) conclude that individual investors with higher number of transaction may results in greater returns than individuals with less number of transactions.

(Luong et.al, 2011) asked the investors to evaluate their own investment performance. In research, rate of return of stock investment is evaluated by asking investors to compare their current real return rates to both their own expected return rates and the average return rate of the security market. In the study,
satisfaction level of investment decisions is anticipated as a decisive factor to measure the investment performance.

1.1.5 Capital Market

The capital Market is an important component of Indian Financial System. It is a formal market for long term funds –both equity and debt- funds raised within and cross border (Bharat.V. Pathak, 2008)

(The Institute of Cost and Works Accountants of India, 2008) The capital market is intended to finance the long-term investments. The dealings in this market are supposed for periods over a year. It is a place where investors buy and sell financial instruments, either equity or debt. It is a process to facilitate the exchange of financial assets.

(Steven Valdez, an Introduction to Global Financial Markets) A capital market is a market for financial assets, for a long or indefinite maturity period. It deals with long term securities which have a maturity period of more than one year. Capital market may be further divided in to three they are: (i) industrial securities market (ii) Govt. securities market and (iii) long term loans market

- **Primary market**: Primary market is a market for new issues. Hence it’s also called new issue market. The primary market deals with those securities which are issued to the public for the first time.
• **Secondary market**: It’s a market for secondary sale of securities. In other words, securities which have already issued in new issue market are traded in this market. Generally, these securities are quoted in the stock exchange and form a continuous and regular market for buying and selling of securities.
1.1.6 Rationale of the Study

- Behaviour, as a general term signifies the action or reaction of something or someone under specified circumstances. A investor's Behaviour of investors while decision making and performance in Capital Market is a new area yet no study has been undertaken on Madhya Pradesh Investors for defining market trend and exploring the new facts and findings which may help stock exchange, stock brokers and as a whole to the Indian financial system in developing the idea to turn Indian economy to international standards, and ensure investors with various facility like for maintaining active trading, safe and fair dealing, dissemination of information etc. Though it will be useful for investors to understand common behaviours, from which they can justify their reactions for better returns. This research targets capital market which gives an outlook of investors’ investment pattern and individual performance towards Primary and secondary market and purpose of conducting this research is to study the base of decision process of investors and to know impact of behaviour biases to investors decision making and investment performance which may act as a tool for developing the economy.
1.1.7 Objectives of the study

- To identify the major characteristics of the respondents which affect Investment decision making.
- To understand the behaviour of investors to invest in capital market via (Educational qualification, Marital Status, Age Group Wise Analysis and Monthly Income).
- To describe the influence level of behavioral variables on the investment decision making.
- To identify the possible behavioural factors influencing the investment decisions of individual investors.
- To identify the impact levels of behavioural factors on the investment decisions and performance of individual investors.
- To analyze the authenticity/reliability of the collected data.
- To open vistas for further research.
1.1.8 Limitation of the study

The study has some limitations they are as the following:

- The study has been done by taking only a sample of 500 respondents. It is suggested to take larger sample size as well to go for to obtain more accurate results.

- The study has been done in Madhya Pradesh region so it is suggested to take larger area or other region so that more appropriate results can be obtained.

- The current study has been conducted in Stock Market i.e. behaviour of respondents in investing in capital market only but research can also be conducted for all kind of securities market.

- To measure the investment performance of investors’ rate of return and satisfaction level is considered. Sometimes investor are not able to calculate their rate of return and satisfaction level so to get more accurate results further measurements of investment performance should be added.

- The study is based on primary data; further researches can be done through secondary data. It saves time.

- Questionnaire used is structured which was improved by adding new variable self control other variables can also be added to get better understanding about the stock market.

- Five point Likert scale is used, for getting more accurate data 7 point likert scale can also be used.
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